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BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF H2O, INC. FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PROPERTY AND FOR AN INCREASE IN ITS WATER RATES AND CHARGES FOR UTILITY SERVICES.	DOCKET NO: W-02234A-07-0557

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H2O, INC.'S

REPLY CLOSING BRIEF

June 29, 2009

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INTRODUCTION

H2O, Inc. ("H2O" or the "Company") hereby submits this Reply Closing Brief in the above-captioned matter. As more fully addressed herein, the Company asserts that: (1) Staff's application of unexpended funds as contributions in aid of construction ("CIAC") and advances in aid of construction ("AIAC") to the Company's rate base (resulting in a negative rate base) is a classic example of a 'mismatch' and does not reflect traditional ratemaking; (2) Staff's concerns regarding the Company's capital structure are better addressed by increasing cash flow available for reinvestment in plant than through the elimination of H2O's Off-Site Capacity Reservation Charge Tariff ("CRC Tariff"); and (3) the minor difference in rate design as proposed by the Company provides a greater degree of revenue stability, which is important to a utility like H2O.

I. RATE BASE ISSUES

In its Initial Closing Brief, Staff relies on the pre-filed testimony of Mr. Aladi to support its proposal to apply unexpended funds as CIAC and AIAC to the Company's rate base, even though there is no corresponding plant in service. Staff Initial Closing Brief ("Staff Brief") at 2-4. However, when cross-examined during the hearing about his pre-filed testimony and the reasons behind Staff's proposal, Mr. Aladi made several concessions that demonstrate why his pre-filed testimony was misguided.[1] He agreed that H2O does not have 'use' of the unexpended funds, and that they are restricted for the cost of future infrastructure to serve developments on an individual, project-specific basis. Hearing Transcript ("TR") at 108-109. He agreed that the underlying reason there is a deduction of CIAC from rate base in Form Schedule B-1 (A.A.C. R14-2-103, Appendix B) is because there is a **logical connection between CIAC and plant-in-service**. TR at 117. And finally, he agreed that the Company's request that the unexpended funds be

[1] Notably, Staff failed to cite any testimony from the hearing transcript in support of Mr. Aladi's pre-filed testimony, which was thoroughly addressed on cross-examination.

added to rate base was immaterial to the ratemaking analysis. TR at 136. Clearly, Mr. Aladi's pre-filed testimony does not support the conclusions and recommendations contained in Staff's Brief.

Staff suggests that the Company's position would not recognize the origin of the unexpended funds. Staff Brief at 3. This demonstrates a fundamental misunderstanding of H2O's position on rate base. The Company agrees that funds provided by a third-party developer should be applied as CIAC, which results in a subtraction from rate base value, *but only when there is a corresponding addition to plant in service that is built with those funds*. Otherwise, the result is a classic regulatory mismatch, as illustrated in the example provided in **Exhibit 1** hereto. As this example shows, applying CIAC in the manner proposed by Staff no longer makes it revenue neutral. This does not reflect traditional ratemaking.

Staff also suggests that the "surplus of advanced and contributed funds is a reflection of the extraordinary growth that H2O has benefited from without having to supply its own investment in order to serve." *Id.* at 4. H2O fails to see where it has benefited as no benefit exists. It has no use of the funds, other than to build off-site infrastructure specifically earmarked and tied to those funds. TR at 108-109. When the funds are actually spent, there will be no excess earnings because the corresponding plant will be constructed using zero-cost capital. TR at 120-121; *see also* Bourassa RJD at 4-5. The Company does not earn a return on and of CIAC-funded plant, and customers enjoy lower rates as a result. In reality, maintaining a surplus of advanced and contributed funds is a liability, not a benefit, if those unexpended funds are used to artificially reduce the Company's rate base in the manner proposed by Staff. Again, Staff's proposed adjustments fail to recognize the logical connection between CIAC and plant-in-service.

For these reasons, H2O requests that the Commission adopt the Company's proposed FVRB of $1,996.695.

II. TERMINATION OF CRC TARIFF

In its brief, Staff expresses serious concerns over H2O's current capital structure, which is heavily reliant on contributed plant, and the long-term effects this has on the Company's ability to invest returns on and of its investment in plant. Staff Brief at 4. However, Staff concedes that elimination of the CRC Tariff will not resolve this issue. *Id.* at 7. Company witness Thomas Bourassa testified that the current imbalance in H2O's capital structure at this time is the result of a timing problem. TR at 55-56. Staff appears to discount Mr. Bourassa's testimony because even if the Company's proposed fair value rate base of $1,995,695 is accepted, it would represent only fifteen percent (15%) of the total $13 million plant in service. *Id.*

H2O submits that a 15% equity ratio places the Company in a far better position to attract capital investment or debt than the negative rate base proposed by Staff. Granted, this amount is still disproportionately low, but *any* positive adjustment to rate base and *any* improvement in the capital structure, no matter how small, is nonetheless a step in the right direction to address Staff's concerns. But capital structure – debt and equity – is not the salient issue in this proceeding. TR at 64-65. Nonetheless, as Mr. Bourassa pointed out during his testimony, once growth returns and the Company begins to build the off-site infrastructure needed to serve such growth, it will require equity investment (or debt) because the amount of funds recovered through the CRC Tariff will not cover the entire cost to build such plant. TR at 55-56.

Elimination of the CRC Tariff is not appropriate at this time. The Company's capital structure – and how to bring it more in line with traditional utilities – is an issue that is not a subject in this proceeding and should be addressed in a future rate proceeding. As Staff suggests, it will take more than simply terminating this hook-up fee to resolve long-term issues related to capitalization. Therefore, H2O asserts that the fair and equitable approach is to address all such issues in a later proceeding, not in piecemeal fashion.

III. RATE DESIGN

Both the Company and Staff agree that a rate design structured to encourage conservation is appropriate. The main difference includes that proportion of revenue that is collected through the monthly minimum charge, versus that portion collected through the commodity charge. The Company is proposing that 44% of its revenue requirement be recovered through the fixed minimum, while Staff is proposing a percentage closer to 35%. TR at 32. Currently, the Company recovers approximately 45% of its revenue requirement from monthly minimum charges. Simply put, the disagreement between the Company and Staff is over striking a proper balance between revenue stability and water conservation goals. H2O asserts that its proposal, which is consistent with the Company's current rate design, strikes that appropriate balance by still sending appropriate water conservation signals without jeopardizing revenue stability.

IV. CONCLUSION

Despite Staff's concerns over the Company's capital structure and over-reliance on contributed plant, H2O customers will still experience a rate reduction as a result of this rate proceeding. If the Company had the means to improve its capital structure into the range recommended by Staff (between 40 to 60 percent equity), then the central issue in this proceeding would be rate shock. Clearly, a gradual reduction in the percentage of contributed plant would allow both shareholders and ratepayers to move the Company towards a more financially viable entity without a sudden sizeable increase in rates. Unfortunately, Staff's proposals on rate base and the elimination of the CRC Tariff would move the Company in the wrong direction towards improving its capital structure, and would make the task of attracting private equity, or acquiring reasonably-priced debt, more daunting than it already is. For the reasons stated above, H2O respectfully requests that adopting its own proposals concerning those issues still in dispute with Staff are in the public interest.

RESPECTFULLY SUBMITTED this 29th day of June, 2009.

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ORIGINAL and thirteen (13) copies
of the foregoing were filed
this 29th day of June, 2009 with:

Docket Control
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Phoenix, Arizona 85007

COPY was hand-delivered
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Exhibit 1

Illustration of Mismtached and Matched Rate Base for unexpended CIAC cash received and commited to fund <u>future</u> plant for <u>future</u> customers

	Simplified Balance Sheet		
Cash (Unexpended CIAC portion)[1]	$	100	Not in Rate base
Plant-in-service, net	$	-	
Total Assets	$	100	
Contributions-in-aid of Construction ("CIAC") (unexpended portion)	$	100	
Equity	$	-	Not in Rate base
Total Liabilities and Equity	$	100	

	[1] Simplified Rate Base (Mismatched)		[2] Simplified Rate Base (Matched)	
Plant-in-service, net	$	-	$	-
Less:				
CIAC	$	(100)	$	-
Net Rate Base[2,3]	$	(100)	$	-
<u>Incremental Revenue Requirement Impact</u>				
Assumed Required ROR		10%		10%
Impact on Revenues[4]	$	(10.00)	$	-
Depreciation and Amortization Impact[5]		(3.50)		-
Income Tax Impact[6]		(5.40)		-
Impact on Revenue Requirement	$	(18.90)	$	-

[1] Cash received from contrbutions which is commited to fund <u>future</u> plant-in-service for <u>future</u> customers.

[2] Net Rate Base reflects the net investment on which the customers (rate payers) must pay a rate of return, or the total of the investment made by the owners and creditors in plant and other items to enable the utility company to render service to the customers.

[3] Rate Base [1] is unbalanced and a mismatch occurs between rate base, revenues and expenses since there is no corresponding investment in plant-in-service for the unexpended cash. Rate Base [2] is a negative, the impact on revenues is negative (negative return $'s), and the impact on operating expenses (depreciation) is negative. Existing customers receive a windfall. In rate making, CIAC is revenue neutral. In other words, it has a net zero impact on rate base, revenues and operating expenses (no depreciation). This is why off-site hook-up fees (CIAC) can be approved outside the context of a rate case. Rate Base [2] is balanced and no mismatch is present. Rate base, revenues and expenses are properly matched. Rate Base [2] is zero, the impact on revenues are zero (no return $'s), and the impact on operating expenses (depreciation) is zero.

[4] Rate Base times Rate of Return

[5] Amortization of CIAC is an offset to depreciation expense. Assumed composite depreciation rate of 3.5%. Depreciation and Amortization equals Plant-in-service times 3.5% less CIAC times 3.5%.

[6] Assumes 40% tax rate.